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12 **UNITED STATES DISTRICT COURT**
 13 **NORTHERN DISTRICT OF CALIFORNIA**
 14 **SAN FRANCISCO DIVISION**

16 BRADLEY C. SMITH, derivatively on behalf of)
 FRANKLIN CUSTODIAN FUNDS,)

17 Plaintiff,)

18 vs.)

19 FRANKLIN/TEMPLETON DISTRIBUTORS,)
 INC., HARRIS J. ASHTON, ROBERT F.)
 20 CARLSON, SAM GINN, EDITH E. HOLIDAY,)
 FRANK W.T. LAHAYE, FRANK A. OLSON,)
 21 LARRY D. THOMPSON, JOHN B. WILSON,)
 CHARLES B. JOHNSON, AND RUPERT H.)
 22 JOHNSON,)

Defendants,)

23 and)

24 FRANKLIN CUSTODIAN FUNDS,)
 Nominal Defendant.)

CV 09 4775
 Civil Action No.

VERIFIED DERIVATIVE COMPLAINT

DEMAND FOR JURY TRIAL

26 **FAXED**
 27
 28

VERIFIED DERIVATIVE COMPLAINT

FILED

OCT - 6 2009

RICHARD W. WIEKING
 CLERK, U.S. DISTRICT COURT
 NORTHERN DISTRICT OF CALIFORNIA

ORIGINAL

B7

1 5. In violation of those laws, the Trust and its distributor/underwriter are paying Asset-
2 Based Compensation to broker-dealers with respect to mutual fund shares held in brokerage
3 accounts rather than advisory accounts. In the plaintiff's case, the Trust and its
4 distributor/underwriter are paying Asset-Based Compensation (calculated as a percentage of
5 average daily net asset value of the shares owned by plaintiff) to Merrill Lynch, which holds
6 plaintiff's shares of the Trust in a brokerage account, and the payments are financed from daily
7 deductions from the Trust's assets.
8

9 6. This action seeks declaratory and injunctive relief to cease the unlawful payments of
10 Asset-Based Compensation on shares held in brokerage accounts; restitution to the Trust from the
11 distributor/underwriter of past unlawful payments; and damages from the Trustees resulting from
12 the breaches of the fiduciary duties of loyalty and due care and their wasting of Trust assets.
13

14 JURISDICTION AND VENUE

15 7. This Court has federal question subject matter jurisdiction over all claims asserted
16 herein pursuant to 15 U.S.C. § 80a-43, and 28 U.S.C. § 1331 and § 1337, because each claim
17 involves issues arising under the ICA, and the rules and regulations thereunder, and this Court has
18 supplemental jurisdiction pursuant to 28 U.S.C. § 1367(a). This action is not a collusive one to
19 confer jurisdiction that the Court would otherwise lack.
20

21 8. This Court has personal jurisdiction over each of the defendants because the Trust's
22 principal place of business is located within this District and all of the defendants have conducted
23 business in this District, including business relating to the claims herein being asserted on behalf of
24 the Trust.

25 9. Venue is proper in this Court pursuant to 28 U.S.C. § 1391(b)(2) and 15 U.S.C. §
26 80a-43 because the Trust maintains its headquarters within this District and because many of the
27 acts complained of herein occurred in this District.
28

THE PARTIES

10. Plaintiff Bradley C. Smith is a resident of North Carolina. Plaintiff owns Class C shares of the Franklin Income Fund, a series of the Trust, and is therefore a shareholder in the Trust. Plaintiff has been a shareholder in the Trust at all times relevant to this Action. Plaintiff's shares are held in a brokerage account at Merrill Lynch.

11. Nominal defendant, the Trust, is a Delaware statutory trust. Prior to February 1, 2008, the Trust was organized as a Maryland corporation. The Trust maintains its principal place of business at One Franklin Parkway, San Mateo, CA 94403-1906. The Trust is classified under the ICA as an open-end management investment company of the series type, and is comprised of five series, or portfolios, commonly known as mutual funds -- Franklin DynaTech Fund, Franklin Growth Fund, Franklin Income Fund, Franklin U.S. Government Securities Fund, and Franklin Utilities Fund (the "Funds"). As of December 31, 2008, the Trust held net assets in excess of \$41.5 billion.

12. Defendant Harris J. Ashton is a current trustee of the Trust. He has served since 1976, and has been classified by the Trust as an independent board member for purposes of the ICA.

13. Defendant Robert F. Carlson is a current trustee of the Trust. He has served since 2007, and has been classified by the Trust as an independent board member for purposes of the ICA.

14. Defendant Sam Ginn is a current trustee of the Trust. He has served since 2007, and has been classified by the Trust as an independent board member for purposes of the ICA.

15. Defendant Edith E. Holiday is a current trustee of the Trust. She has served since 1998, and has been classified by the Trust as an independent board member for purposes of the ICA.

1 16. Defendant Frank W.T. LaHaye is a current trustee of the Trust. He has served since
2 2007, and has been classified by the Trust as an independent board member for purposes of the
3 ICA.

4 17. Defendant Frank A. Olson is a current trustee of the Trust. He has served since
5 2005, and has been classified by the Trust as an independent board member for purposes of the
6 ICA.

7 18. Defendant Larry D. Thompson is a current trustee of the Trust. He has served since
8 2007, and has been classified by the Trust as an independent board member for purposes of the
9 ICA.

10 19. Defendant John B. Wilson is a current trustee of the Trust. He has served since
11 2007, and has been classified by the Trust as an independent board member for purposes of the
12 ICA.

13 20. Defendant Charles B. Johnson is a current trustee of the Trust. He has served since
14 1969, and has been classified by the Trust as an interested board member for purposes of the ICA.

15 21. Defendant Rupert H. Johnson, Jr. (brother of Charles B. Johnson) is a current trustee
16 of the Trust. He has served since 1983, and has been classified by the Trust as an interested board
17 member for purposes of the ICA. The defendants referenced in ¶¶ 12-21 are referred to collectively
18 herein as the "Trustee Defendants."

19 22. Defendant Franklin/Templeton Distributors, Inc. ("Distributors") is a New York
20 corporation with its principal place of business at One Franklin Parkway, San Mateo, CA 94403-
21 1906. Distributors is a wholly-owned subsidiary of Franklin Resources. Franklin Resources is a
22 holding company, and its operating subsidiaries do business collectively as "Franklin Templeton
23 Investments." Distributors acts as the principal underwriter/distributor for shares in the Trust.
24 Distributors is a broker-dealer member of FINRA. Pursuant to a distribution agreement with the
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1 Trust, Distributors enters into selling agreements with retail broker-dealers (referred to in the
2 distribution agreement as “sub-agents”), who act in an agency capacity for Distributors in the
3 distribution of shares of the Trust to members of the public.

4 **DEFENDANTS’ DUTIES**

5 23. Pursuant to the ICA, and SEC Rule 38a-1 promulgated thereunder, the trustees of a
6 mutual fund series have ultimate responsibility to ensure compliance with the federal securities laws
7 by service providers acting on behalf of the mutual funds, such as the funds’ distributor and
8 investment manager. *See* 17 C.F.R. § 270.38a-1. The Advisers Act is one of the federal securities
9 laws that the Trustees are required to enforce.

10 24. The Advisers Act mandates certain disclosure, liability, record keeping and conflict
11 management requirements to protect the clients of professional investment advisors. Unless a
12 statutory exclusion applies, the Advisers Act will govern any customer account at a retail broker-
13 dealer firm, because those firms come under the statute’s coverage by making securities
14 recommendations, conducting suitability reviews, and otherwise providing investment advice to
15 their customers.

16 25. Under what is known as the “Broker-Dealer Exclusion,” a brokerage account at a
17 broker-dealer may avoid the requirements of the Advisers Act if the broker-dealer’s compensation
18 is limited to transactional commissions on the purchase or sale of securities, and if investment
19 advice to the customer is merely “incidental” to providing brokerage services. *See* 15 U.S.C. § 80b-
20 2(11)(C). Brokerage accounts are governed by the Securities Exchange Act of 1934 and the self-
21 regulatory regime mandated therein, including the rules of conduct promulgated by the broker-
22 dealer industry’s self-regulatory organization, the Financial Industry Regulatory Authority
23 (FINRA), formerly known as NASD. If the Broker-Dealer Exclusion does not apply, and no other
24 exclusion applies, the broker-dealer must establish what is commonly referred to as an “advisory
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1 account” for the customer (as opposed to a “brokerage account”), *i.e.* an account governed by the
2 Advisers Act.

3 26. Another statutory exclusion from the Advisers Act allows the Securities and
4 Exchange Commission (SEC) to designate other persons by regulation to be excluded from the
5 Advisers Act (hereinafter referred to as the “SEC Designates Exclusion”). *See* 15 U.S.C. § 80b-
6 2(11)(F).

7
8 27. For most of the last two decades, leading up to the 2007 court ruling in *Financial*
9 *Planning Association v. SEC*, the SEC encouraged broker-dealers to shift to Asset-Based
10 Compensation in order to reduce churning and other sales abuses tied to transactional commissions.
11 Asset-Based Compensation, *i.e.* ongoing monthly or quarterly payments based on a percentage of
12 the average daily net asset value of the shares held in the account, is not a form of transactional
13 commission, and therefore Asset-Based Compensation may not be paid on accounts that seek to
14 qualify for the Broker-Dealer Exclusion.

15
16 28. However, in order to promote the shift to Asset-Based Compensation, the SEC
17 enacted a new Rule under the Advisers Act, under what the agency believed to be its statutory
18 authority under the SEC Designates Exclusion. The new rule, SEC Rule 202(a)(11)-1, provided
19 that broker-dealers may receive Asset-Based Compensation from brokerage accounts without the
20 need to comply with the Advisers Act, so long as certain criteria are satisfied, including a
21 requirement that the customer is given a written disclosure explaining that the account is a
22 brokerage account and not an advisory account.

23
24 29. In *Financial Planning Association v. SEC*, the D.C. Circuit vacated SEC Rule
25 202(a)(11)-1, holding that the SEC lacked any jurisdictional basis to promulgate the rule, given that
26 the rule directly conflicts with the existing statutory Broker-Dealer Exclusion prohibiting Asset-
27 Based Compensation in connection with brokerage accounts. Accordingly, as a result of the
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1 decision, which by its terms became effective as of October 1, 2007, broker-dealers may not
2 lawfully receive Asset-Based Compensation with respect to securities held in brokerage accounts.

3 30. Therefore, mutual funds (like the Trust) must, prior to making or allowing any
4 payments of Asset-Based Compensation to broker-dealer firms in connection with customer
5 accounts, ensure that the compensation is being paid only with respect to "advisory accounts," in
6 order to maintain compliance with the Advisers Act. If the account is an "advisory account," then
7 the broker-dealer firm may lawfully receive Asset-Based Compensation. If the account is a
8 "brokerage account," then receipt of Asset-Based Compensation is unlawful, unless the parties can
9 identify some other applicable statutory exclusion to the Advisers Act.
10

11 31. Mutual funds organized as trusts, such as the Trust, are governed by a Board of
12 Trustees. As stated in Section 36(a) of the ICA, and under governing state law, mutual fund
13 directors and trustees have a fiduciary duty of care to the Trust, the highest standard of care known
14 in the law. By reason of their positions as trustees, the Trustee Defendants owed the Trust and its
15 shareholders fiduciary obligations of trust, loyalty, good faith and due care, and were and are
16 required to use their utmost ability to control and manage the Trust in a fair, just, honest and
17 equitable manner.
18

19 32. Additionally, as reflected by the ICA and Rule 38a-1 adopted thereunder, mutual
20 fund directors and trustees must oversee service providers to the mutual fund to ensure that these
21 parties (typically affiliated with the funds' sponsor or promoter) are both complying with the law
22 and acting in the shareholders' best interests, rather than the pecuniary interests of the sponsor.¹
23

24
25 ¹ As explained by the Investment Company Institute ("ICI"), the mutual fund industry's
26 Washington D.C.-based lobbying organization: "Unlike the directors of other corporations, mutual
27 fund directors are responsible for protecting consumers, in this case, the fund's investors. This
28 unique 'watchdog' role, which does not exist in any other type of company in America, provides
investors with the confidence of knowing that directors oversee the advisers who manage and
service their investments. In particular, under the Investment Company Act of 1940, the board of
directors of a mutual fund is charged with looking after how the fund operates and overseeing
matters where the interests of the fund and its shareholders differ from the interests of its investment

1 33. Rule 38a-1 was adopted following a series of scandals that rocked the mutual fund
 2 industry in 2003, in which service providers to some mutual funds were discovered to be making
 3 improper and illegal arrangements abusive to fund investors, due to inadequate or ineffective
 4 oversight by fund directors/trustees. *See, e.g.*, “Special Report: Breach of Trust,” BusinessWeek
 5 (Dec. 15, 2003) (available at www.businessweek.com).²
 6

7 34. In reaction to these scandals, on December 24, 2003, the SEC adopted new Rule 38a-
 8 1 under the ICA. *See* 17 C.F.R. § 270.38a-1. Rule 38a-1 mandates certain practices designed to
 9 strengthen the ability of mutual fund boards to effectively exercise their duty to prevent, detect and
 10 correct violations of the federal securities laws by service providers.

11 35. In particular, Rule 38a-1 requires the board of a mutual fund to approve the written
 12 compliance policies and procedures in place at each service provider, including the distributor, that
 13 are reasonably designed to prevent, detect and correct violations of the federal securities laws,
 14 including the ICA and the Advisers Act, by that service provider.
 15

16 36. Rule 38a-1 also requires the board to elect a Chief Compliance Officer (“CCO”).
 17 The CCO is required to provide an annual written report to the board that addresses the operation of
 18 the compliance policies and procedures of the mutual fund and each of its service providers. The
 19

20 adviser or management company.” *See* Brochure titled “Understanding the Role of Mutual Fund
 21 Directors” (1999) available at www.ici.org.

22 The ICI also stated in its 1999 brochure: “Because mutual fund directors are, in essence, looking out
 23 for shareholders’ money, the law holds directors to a very high standard of behavior in carrying out
 24 their responsibilities. They must act with the same degree of care and skill that a reasonably
 25 prudent person would use in the same situation or in connection with his or her own money.
 26 Lawyers call this being a ‘fiduciary’ or having a ‘fiduciary duty.’” *Id.*

26 ² *See also* “The Mutual Fund Scandal: Unfair Fight,” Newsweek (Dec. 8, 2003)
 27 (www.newsweek.com/id/60819); Alan R. Palmiter, “The Mutual Fund Board: A Failed Experiment
 28 In Regulatory Outsourcing,” 1 Brook. J. Corp. Fin. & Com. L. 165 (Fall 2006); Patrick E. McCabe,
 “The Economics Of The Mutual Fund Trading Scandal,” Board of Governors of the Federal
 Reserve System staff working paper # 2009-06 (available at www.federalreserve.gov).

1 report must also address any "material compliance matter," which is defined to include a violation
2 of the federal securities laws by the service provider "or agents thereof." *See* 17 C.F.R. § 270.38a-
3 1(e)(2)(i).

4 37. In addition, the CCO is required to meet in executive session with the independent
5 trustees at least once each year, without the presence of anyone else (such as fund management or
6 interested trustees), other than independent counsel to the independent trustees. This allows the
7 CCO and independent trustees to speak freely about any sensitive compliance issues of concern to
8 any of them, including any reservations about the cooperativeness or compliance practices of fund
9 management or service providers.
10

11 38. The following deadlines were established in connection with the implementation of
12 initial Rule 38a-1: board approval of the compliance policies and procedures of the mutual fund
13 and each of its service providers was required by October 5, 2004; the first annual review of the
14 adequacy and effectiveness of the funds' and service providers' policies and procedures was due by
15 April 5, 2006; and the first annual report by the CCO to the board to address the results of the
16 annual compliance review was required by June 4, 2006.
17

18 39. Accordingly, the Trustee Defendants have ultimate responsibility for service
19 providers' compliance with the federal securities laws, including compliance with the requirements
20 of the Advisers Act, as applicable, in connection with the distribution of Trust shares. The Trustee
21 Defendants were required to review and approve the compliance policies and procedures in place at
22 Distributors. The Trustee Defendants were required to hold formal annual board reviews, since at
23 least June 4, 2006, in which the Trustees were supposed to evaluate the adequacy and effectiveness
24 of Distributors' compliance procedures.
25

26 40. The Trust's CCO, James M. Davis, reports directly to the Board. He is required to
27 make annual compliance reports to the Board, including reports of any material compliance issues
28

1 facing Defendant Distributors and the retail broker-dealers that act as sub-agents for Distributors,
2 including, specifically, any issues concerning compliance with the Advisers Act. Mr. Davis is also
3 required to meet at least annually in executive sessions with the independent Trustees to discuss
4 material compliance issues.

5
6 41. The Trustees have failed to perform their duty to enforce compliance with the
7 Advisers Act. The Trust and its service providers are paying Asset-Based Compensation to broker-
8 dealers in connection with Trust shares held by customers in brokerage accounts. The Trust, as
9 distributor of its own shares, directly makes “Rule 12b-1 payments” out of Trust assets to
10 Distributors, a broker-dealer that sub-appoints other broker-dealer firms to distribute Trust shares on
11 an agency basis on behalf of the Trust.³ Pursuant to distribution plans approved by a majority of the
12 independent Trustees under SEC Rule 12b-1, 17 C.F.R. § 270.12b-1, these ongoing payments are
13 calculated based on daily net asset values of shares held in customer accounts.⁴ In addition,
14 Distributors makes ongoing “marketing support payments” to broker-dealers based on daily net
15 asset values of shares held in customer accounts. The ongoing payments continue despite the fact
16 that Distributors and the broker-dealers that maintain the accounts cannot lawfully receive Asset-
17 Based Compensation calculated on Trust shares held in brokerage accounts.

18
19 42. These unlawful payments of Asset-Based Compensation to broker-dealers in
20 connection with brokerage accounts improperly deplete the assets of the Trust, and deprive Trust
21 shareholders of the protections and benefits of the advisory accounts to which they are entitled
22 under law.

23
24 ³ For example, in the fiscal year ending September 30, 2008, the Trust funded payment of
25 approximately \$99.2 million in Asset-Based Compensation to broker-dealers pursuant to a Rule
26 12b-1 distribution plan for Class C shares.

27 ⁴ Rule 12b-1 also requires the Trustees to review “at least quarterly, a written report of the amounts
28 so expended and the purposes for which such expenditures were made,” thus providing the Board
with numerous additional opportunities to ascertain that Asset-Based Compensation was improperly
being paid in connection with brokerage accounts.

SUBSTANTIVE ALLEGATIONS

Advisers Act's Application To Broker-Dealers

43. Broker-dealer firms are regulated by the Securities Exchange Act of 1934, which defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others" and a "dealer" as "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise." 15 U.S.C. § 78c(a)(4)(A), (5)(A). Firms that are brokers are commonly referred to as "brokerage firms" or "broker-dealers" and accounts that they maintain for their customers are commonly referred to as "brokerage accounts."

44. In 1940, Congress established a different regulatory regime for persons who provide investment advice for compensation by enacting the Advisers Act, which defines an "investment adviser" as "any person who, for compensation, engages in the business of advising others. . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities. . . ." 15 U.S.C. § 80b-2(11). Client accounts that are subject to the Advisers Act are commonly referred to as "advisory accounts."

45. Full-service broker-dealers fall within the definition of investment adviser, because (i) the package of services provided by broker-dealers includes advice; and (ii) broker-dealers receive compensation for the package of services they provide.

46. A person comes within the definition of "investment adviser" in the Advisers Act even if compensation is paid to him or her by a third party rather than his or her client. The compensation element of the "investment adviser" definition is "satisfied by the receipt of any economic benefit, whether in the form of an advisory fee or some other fee relating to the total services rendered, commissions, or a combination of the foregoing. Moreover, it is not necessary that the adviser's compensation be paid directly by the person receiving the investment advisory

1 services; the adviser need only receive compensation from some source for his services.” *College*
2 *Resource Network*, 1993 SEC No-Act. LEXIS 630 (Apr. 9, 1993) (citations omitted).

3 47. In enacting the Advisers Act, Congress recognized that broker-dealers fall within the
4 definition of “investment adviser.” However, Congress did not intend to displace the broker-dealer
5 salesperson business model, and therefore included in the statute an exception from the definition of
6 “investment adviser” for a broker or dealer that provides advice “solely incidental to the conduct of
7 his business as a broker or dealer and who receives no special compensation therefor.” 15 U.S.C. §
8 80b-2(11)(C) (hereinafter, the “Broker-Dealer Exclusion”).

9 48. Although the terms “solely incidental” and “special compensation” in the Broker-
10 Dealer Exclusion are not defined in the Advisers Act, it was understood from the inception of the
11 legislation that broker-dealers can avoid Advisers Act requirements only “insofar as their advice is
12 merely incidental to brokerage transactions for which they receive only brokerage commissions.” S.
13 Rep. No. 76-1775, 76th Cong., 3d Sess. 22 (1940).

14 49. Broker-dealers typically seek to avoid Adviser Act regulation because the standard
15 of care required of investment advisers is higher than the standard for broker-dealers. A 204-page
16 SEC-sponsored report, published on January 8, 2008, authored by the RAND Corporation, titled
17 “Investor and Industry Perspectives on Investment Advisers and Broker-Dealers,” (available at
18 www.sec.gov/news/press/2008/2008-1.htm) (“RAND Report”), contains an extensive comparison
19 of the legal duties owed by broker-dealers versus investment advisers.⁵ The RAND Report
20 observes that “unlike broker-dealers, federally registered investment advisers owe fiduciary
21 obligations to their clients as a *categorical* matter. . . such obligations require the adviser to act
22 solely with the client’s investment goals and interests in mind, free from any direct or indirect
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27 ⁵ The RAND Report notes that its discussion of the differences in regulation between broker-dealers
28 and investment advisers “is by no means a complete exegesis of the copious regulatory distinctions
within these fields, which would require volumes.” Rand Report at 7 n. 1.

1 conflicts of interest that would tempt the adviser to make recommendations that would also benefit
2 him or her. . . . The fiduciary duties imposed on investment advisers require any adviser either to
3 refrain from acting with a conflict of interest or to fully disclose the conflict and receive specific
4 consent from the client to so act. Examples of such conflicts include various practices in which an
5 adviser may have pecuniary interest[.]” RAND Report at 13 (emphasis in original).
6

7 50. In the 1990’s, many broker-dealer firms sought to shift from traditional brokerage
8 commissions to Asset-Based Compensation, without incurring Advisers Act regulation. The
9 movement was further legitimized after a group of securities industry representatives (known as the
10 “Tully Committee,” because it was chaired by Daniel Tully of Merrill Lynch) issued a report to the
11 SEC in April 1995 that recommended asset-based compensation as a broker-dealer “best practice”
12 that reduces churning and unsuitable securities recommendations motivated by transactional
13 commissions. See Report of the Committee on Compensation Practices (April 10, 1995), available
14 at www.sec.gov/news/studies/bkrcomp.txt .
15

16 51. In support of asset-based compensation, the Tully Committee cited the overall
17 desirability of compensating the relationship between a broker and his or her customer for trusted
18 advice, rather than compensating for sales transactions. See *id.* at 4 (“The most important role of
19 the registered representative is, after all, to provide investment counsel to individual clients, not to
20 generate transaction revenues. The prevailing commission-based compensation system inevitably
21 leads to conflicts of interest among the parties involved.”).
22

23 52. Mutual fund companies innovatively met the broker-dealer industry’s new demand
24 for asset-based compensation by introducing new share classes of their mutual funds, such as “C-
25 shares.” With these new share classes, transactional sales loads, which are shareholder charges that
26 are remitted to broker-dealers, are reduced or eliminated, in favor of asset-based compensation for
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1 broker-dealers that is funded by ongoing 12b-1 fees and/or other fees imbedded in the mutual fund's
2 internal expense structure (rather than a visible shareholder charge).

3 53. The SEC, including then Chairman Arthur Levitt, endorsed the Tully Committee
4 recommendations, and sought to resolve the legal barrier to asset-based compensation for broker-
5 dealers. SEC staff had concluded that the Broker-Dealer Exclusion, with its bright-line focus on the
6 form of compensation, was "outdated," and viewed asset-based compensation as merely a
7 "repricing" of the same package of brokerage services provided to customers paying transactional
8 commissions, for which the Advisers Act requirements were avoided.
9

10 54. In speeches and other public communications, SEC staff disagreed with those who
11 were arguing, on policy grounds, that the existing Broker-Dealer Exclusion focuses on the form of
12 compensation for good reasons. Asset-based compensation creates an ongoing relationship between
13 the broker-dealer and the customer. This, in turn, fosters an expectation by the client that his or her
14 adviser has ongoing duties to him or her for as long as the compensated relationship is maintained.
15 By contrast, broker-dealer firms receiving transactional commissions have legal duties under federal
16 law to their customers that are limited to their role in the purchase or sale of securities. Therefore,
17 the Broker-Dealer Exclusion appropriately reflects that only broker-dealers receiving transactional
18 compensation are intended to be excluded from the requirements of the Advisers Act. SEC staff
19 agreed that the Broker-Dealer Exclusion prohibited asset-based compensation, but did not find any
20 of the policy arguments against expanding the Broker-Dealer Exclusion to be persuasive.
21
22

23 55. Relying on the SEC Designates Exclusion to the Advisers Act, see 15 U.S.C. § 80b-
24 2(11)(G), the SEC cleared the way for Asset-Based Compensation for broker-dealers with a new
25 rule allowing broker-dealers to receive "special compensation" in connection with brokerage
26 accounts, so long as their investment advice is "solely incidental to the brokerage services provided
27 to those accounts" and account agreements include a "prominent statement that the accounts are
28

1 brokerage accounts.” *See* Notice of Proposed Rule, Certain Broker-Dealers Deemed Not To Be
2 Investment Advisers, 64 Fed. Reg. 61,226 (Nov. 4, 1999) (the “1999 NOPR”) (proposing new SEC
3 Rule 202(a)(11)-1).

4 56. In the 1999 NOPR, the SEC acknowledged that the Advisers Act prohibits broker-
5 dealers from receiving asset-based compensation. As its statutory authority for the new rule, the
6 SEC cited the SEC Designates Exclusion, which states that the SEC may except “such other persons
7 within the intent of this paragraph as the Commission may designate by rules and regulations or
8 order” from the definition of investment adviser. 15 U.S.C. § 80b-2(11)(G).

9
10 57. The release included an interim “no action” position by SEC staff allowing broker-
11 dealers to receive “special compensation” while the proposed rule was being considered: “Until the
12 Commission takes final action on the proposed rule, the Division of Investment Management will
13 not recommend, based on the form of compensation received, that the Commission take any action
14 against a broker-dealer for failure to treat any account over which the broker-dealer does not
15 exercise investment discretion as subject to the [Advisers] Act.”

16
17 58. The proposed rule published in the 1999 NOPR was never submitted for a final vote
18 at the SEC.

19 59. In 2004, the Financial Planning Association (“FPA”), a group whose members are
20 registered investment advisers, sued the SEC in the United States Court of Appeals for the District
21 of Columbia (the “D.C. Circuit Court of Appeals”). The FPA asserted that the SEC had violated the
22 Administrative Procedures Act for failing to either publish a final rule or withdraw the “temporary”
23 no action position. The FPA was interested in forcing the SEC to issue a final rule that could be
24 challenged in court. FPA members complied with the Advisers Act but had to compete in the
25 marketplace against broker-dealers providing similar services through brokerage accounts not
26 subject to the Advisers Act, which the FPA perceived as unfair competition.
27
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1 60. Thereafter, the SEC re-published the proposed rule for fresh public comment, issued
2 a formal temporary regulation and, subsequently, promulgated a final rule. *See* 70 Fed. Reg. 20424
3 (Apr. 19, 2005).

4 61. In the final rule, the SEC expanded the disclosure required for any brokerage account
5 in which “special compensation” is received. The SEC mandated disclosure read as follows: “Your
6 account is a brokerage account and not an advisory account. Our interests may not always be the
7 same as yours. Please ask us questions to make sure you understand your rights and our obligations
8 to you, including the extent of our obligations to disclose conflicts of interest and to act in your best
9 interest. We are paid both by you and, sometimes, by people who compensate us based on what you
10 buy. Therefore, our profits, and our salespersons' compensation, may vary by product and over
11 time.” The customer statement is also required to identify “an appropriate person at the firm with
12 whom the customer can discuss the differences” between advisory and brokerage accounts. *See* 17
13 C.F.R. § 275.202(a)(11)-1.

14 62. The revised disclosure requirement applied to brokerage accounts opened on or after
15 July 22, 2005 for which broker-dealers were relying on the new rule to receive “special
16 compensation.” *See* 70 Fed. Reg. 20424, 20441 (Apr. 19, 2005).

17 63. Relying on Section 213 of the Advisers Act, which allows a “party aggrieved” by an
18 SEC order to obtain a federal Court of Appeals review, the FPA subsequently challenged the SEC’s
19 authority to promulgate Rule 202(a)(11)-1 by petition to the D.C. Circuit Court of Appeals.

20 64. Because the Broker-Dealer Exclusion plainly prohibits broker-dealers from receiving
21 “special compensation,” the Court considered the SEC’s argument that broker-dealers that receive
22 “special compensation” are “other persons within the intent” of Congress to exclude, and, as such,
23 could be excluded from the Advisers Act by virtue of SEC rulemaking under the SEC Designates
24 Exclusion. 15 U.S.C. § 80b-2(11)(G). The majority on the D.C. Circuit Court of Appeals panel
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1 rejected the SEC's argument, finding that broker-dealers cannot be "other persons" that the SEC
2 could except by regulation, nor could broker-dealers receiving "special compensation" be a group
3 of persons that were within the intent of the Advisers Act to except, since the Broker-Dealer
4 Exclusion plainly states that broker-dealers cannot receive "special compensation." *See Financial*
5 *Planning Association v. SEC*, 482 F.3d 481, 488-89 (D.C. Cir. 2007).
6

7 65. The dissenting opinion agreed with the majority that asset-based compensation is
8 "special compensation." *Id.* at 494. The dissent also agreed with the majority that "a broker-dealer
9 who receives any kind of compensation other than commission does not come within the [Broker-
10 Dealer Exclusion], even if he, too, provides advice solely as an incident to his business as a broker-
11 dealer." *Id.* However, unlike the majority, the dissenting judge would have allowed the SEC to
12 proceed under the SEC Designates Exclusion to authorize "special compensation," based on the
13 judge's view that the "other persons" language in the SEC Designates Exclusion is ambiguous, and
14 that the SEC had made a reasonable interpretation of its rulemaking authority to classify broker-
15 dealers that receive "special compensation" as "other persons." *Id.*
16

17 66. Therefore, the *Financial Planning Association* decision reflects that the SEC, the
18 D.C. Circuit Court of Appeals majority, and the dissenting judge, were all in agreement that asset-
19 based compensation is "special compensation" and that broker-dealers are prohibited by the
20 Advisers Act from receiving such compensation, unless SEC Rule 202(a)(11)-1 was a valid exercise
21 of SEC rulemaking authority.
22

23 67. Accordingly, the *Financial Planning Association* decision, striking SEC Rule
24 202(a)(11)-1 in its entirety as invalid, confirms that broker-dealers may not lawfully receive asset-
25 based compensation in connection with brokerage accounts in the United States.

26 68. The SEC decided not to appeal the ruling vacating SEC Rule 202(a)(11)-1, and
27 requested a stay of mandate to give regulated parties time to transition brokerage accounts receiving
28

1 special compensation to either advisory accounts or to brokerage accounts receiving transaction
2 commissions. The D.C. Circuit Court of Appeals subsequently stayed its mandate until October 1,
3 2007. *See* 2007 U.S. App. LEXIS 15169 (D.C. Cir. June 25, 2007).

4 69. Pursuant to Section 38(c) of the ICA, and Section 211(d) of the Advisers Act,
5 regulated parties are not liable for good faith reliance on SEC rules, regulations or orders prior to
6 the time that such rule, regulation or order is “determined by judicial or other authority to be invalid
7 for any reason.”

9 70. Accordingly, prior to October 1, 2007, broker-dealers may lawfully have received
10 Asset-Based Compensation only in connection with brokerage accounts for which they can
11 demonstrate compliance with former SEC Rule 202(a)(11)-1, including compliance with the
12 disclosure requirement of the now vacated rule. *See* SEC Rule 202(a)(11)-1(a)(1)(ii).

13 71. As of October 1, 2007, broker-dealers may not lawfully receive Asset-Based
14 Compensation in connection with brokerage accounts in the United States.

16 72. On September 28, 2007, the SEC published for comment a proposed interpretative
17 rule under the Advisers Act that reinstates certain portions of the original rule vacated by the
18 *Financial Planning Association* decision. One reinstated provision is that a “broker or dealer
19 registered with the Commission under Section 15 of the Exchange Act is an investment adviser
20 solely with respect to those accounts for which it provides services or receives compensation that
21 subject the broker-dealer to the Advisers Act.” *See* Proposed SEC Rule 202(a)(11)-1(c),
22 “Interpretive Rule Under the Advisers Act Affecting Broker-Dealers,” 72 Fed. Reg. 55126 (Sept.
23 28, 2007). The SEC states in its release that this interpretive guidance was not previously
24 challenged in the Court proceeding, and was being re-promulgated to permit a firm that is a dual
25 registrant, *i.e.* registered both as a broker-dealer and an investment advisory firm, “to distinguish its
26 brokerage customers from its advisory clients.” No final rule has been issued.
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Defendants' Duty To Enforce The Advisers Act

73. As discussed above, the ICA and SEC Rule 38a-1 provide that the Trustee Defendants have ultimate responsibility for ensuring that payments by the Trust and its service providers are in compliance with the federal securities laws, including the Advisers Act. The Trustee Defendants failed to perform this duty.

74. Specifically, in the period from July 22, 2005 to September 30, 2007, the Trustee Defendants failed to ascertain whether Distributors had compliance policies and procedures in place to ensure that broker-dealers receiving Asset-Based Compensation payments in connection with Trust shares held in brokerage accounts that were opened in that period were in compliance with the conditions set forth in former SEC Rule 202(a)(11)-1 for receipt of such compensation. In the period from October 1, 2007 to present, the Trustee Defendants failed to ascertain whether Distributors had compliance policies and procedures in place to ensure that Asset-Based Compensation is paid only to registered investment advisers, or broker-dealers that are dual registrants, and that Trust shares upon which such compensation is paid are held in advisory accounts governed by the Advisers Act.

75. As a result of the Trustee Defendants' breaches of their fiduciary duties, the Trust and its service providers made and continue to make unlawful payments of Asset-Based Compensation to broker-dealers in connection with Trust shares held in brokerage accounts. These unlawful payments constitute a *per se* waste of Trust assets, causing harm to the Trust and its shareholders. In addition, the Trustee Defendants' failure to enforce the Advisers Act has caused, and continues to cause, shareholders to be deprived of the investor protections and benefits of advisory accounts that they are entitled to as a matter of law.

ADDITIONAL DERIVATIVE AND DEMAND REQUIREMENT ALLEGATIONS

76. In addition to the allegations set forth above, as described below, plaintiff brings this action derivatively in the right and for the benefit of the Trust to redress injuries suffered and to be suffered by the Trust as a direct result of the violations of law by Defendant Distributors and the Trustee Defendants, for which demand on the Trust's Board of Trustees was made. The Trust is named as a nominal defendant solely in a derivative capacity.

77. Plaintiff will adequately and fairly represent the interests of the Trust and its shareholders in enforcing and prosecuting their rights.

78. Through his attorneys, plaintiff made demand on the Trust's Board of Trustees. By letter dated January 8, 2009, plaintiff demanded that the Board cause the Trust and its service providers to cease funding and paying Asset-Based Compensation to broker-dealers in connection with Trust shares held in brokerage accounts in the United States, to restore to the Trust certain of such payments made in the past, and to remedy the Trustees' breaches of their fiduciary duties of loyalty and due care, and their waste of Trust assets. Exhibit 1.

79. By letter dated March 4, 2009, counsel for "the Trustees of the Franklin Custodian Funds who are not 'interested persons' of such Fund" responded that: "The Board of Trustees has carefully considered Mr. Smith's demands on behalf of the Trust, and has sought and considered legal advice on the subject matter of the demands. The Board of Trustees has determined that the demands are not well-founded, as a matter of law, and declines to take the steps, including litigation, that you propose." Exhibit 2.

80. The response to the demand is a wrongful refusal, for the reasons stated in this complaint, and does not give any business judgment reasons for the Board of Trustees' failure to act. In any event, the federal policies underlying the claims asserted herein preempt any state law

1 grounds for terminating this litigation. Accordingly, the prosecution of these claims on a
2 shareholder derivative basis is appropriate.

3 **FIRST CAUSE OF ACTION**

4 **Violation Of Section 47(b) Of The ICA Against Defendant Distributors**

5 81. Plaintiff incorporates by reference each of the foregoing allegations as if fully stated
6 herein.

7
8 82. Section 47(b) of the ICA provides that a contract made in violation of the ICA, or
9 whose performance involves a violation of the ICA, or any rule thereunder, is unenforceable by
10 either party, and provides for whole or partial rescission and restitution. The Trust is entitled to
11 void the broker-dealer compensation provisions in its distribution agreement between the Trust and
12 Distributors because these provisions were made in violation of, and their performance involves
13 violations of, the ICA insofar as these provisions authorize using Trust assets for illegal payments,
14 and violate the mandate of the ICA and SEC Rule 38a-1 that the Trust and its service providers, and
15 agents of service providers, comply with all applicable federal securities laws, including the
16 Advisers Act.
17

18 83. Past unlawful payments to Distributors and its sub-agents pursuant to the distribution
19 agreement constitute unjust enrichment to be restituted to the Trust by Distributors, as follows: for
20 the period July 22, 2005 to September 30, 2007, the amount of the past payments of Asset-Based
21 Compensation to Distributors and/or its sub-agents in connection with Trust shares held in
22 brokerage accounts in which the requirements of former SEC Rule 202(a)(11)-1 were not satisfied,
23 and from the period of October 1, 2007 to present, the amount of Asset-Based Compensation in
24 connection with Trust shares held in brokerage accounts paid to Distributors and/or its sub-agents.
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SECOND CAUSE OF ACTION

Breach of Contract Against Defendant Distributors

84. Plaintiff incorporates by reference each of the foregoing allegations as if fully stated herein.

85. In the operative written distribution agreement between the Trust and Distributors, Distributors, on behalf of itself and its sub-agent broker-dealers, warranted that it would comply with the federal securities laws.

86. In material breach of its contractual promise, Distributors has received and continues to receive Asset-Based Compensation from Trust assets in connection with Trust shares held in brokerage accounts, which is prohibited by the Advisers Act.

87. As a result of Distributors' breach, there has been a *per se* waste of Trust assets, causing harm to the Trust and its shareholders. In addition, Distributors' breach of contract caused Trust shareholders to be deprived of advisory accounts subject to the investor protections and benefits of the Advisers Act. The Trust's damages equal, for the period July 22, 2005 to September 30, 2007, the amount of the past payments of Asset-Based Compensation to Distributors and/or its sub-agents in connection with Trust shares held in brokerage accounts in which the requirements of former SEC Rule 202(a)(11)-1 were not satisfied, and from the period of October 1, 2007 to present, the amount of Asset-Based Compensation in connection with Trust shares held in brokerage accounts paid to Distributors and/or its sub-agents.

THIRD CAUSE OF ACTION

Breach of Fiduciary Duty Against The Trustee Defendants

88. Plaintiff incorporates by reference each of the foregoing allegations as if fully stated herein.

89. The Trustee Defendants are fiduciaries of the Trust and of all of its shareholders and owe them the duty to conduct the affairs of the Trust loyally, faithfully, carefully, diligently and

1 prudently. This cause of action is asserted based upon the Trustee Defendants' acts in violation of
2 state law, which acts constitute breach of fiduciary duty.

3 90. Each of the Trustee Defendants participated in the acts of mismanagement alleged
4 herein, or acted in reckless disregard of the facts and law known to them, and failed to exercise due
5 care to prevent the misuse of Trust assets. The Trustee Defendants became aware, or should have
6 become aware through reasonable inquiry, of the facts alleged herein including, among others, the
7 deficiencies in the compliance policies and procedures of the Trust and its service providers
8 permitting unlawful payments of Asset-Based Compensation to broker-dealers in connection with
9 Trust shares held in brokerage accounts. The Trustee Defendants thereby breached their duty of
10 care and loyalty to the shareholders of the Trust by failing to act as an ordinary prudent person
11 would have acted in a like position.
12

13 91. Each of the Trustee Defendants also engaged in an intentional dereliction of duty and
14 demonstrated a conscious disregard for his or her responsibilities. The Board of Trustees had an
15 affirmative duty to investigate the legality of the broker-dealer compensation payments, including
16 through mandated quarterly reviews of 12b-1 fee payments, and the annual compliance reviews of
17 service providers, mandated by SEC rules, including determining whether Trust shares were held in
18 brokerage accounts. The Trustee Defendants thereby acted in bad faith to the shareholders of the
19 Trust by failing to act as an ordinary prudent person would have acted in a like position.
20

21 92. As a result of the foregoing, the Trust has suffered considerable damage to and
22 material diminution in the value of its assets paid as illegal compensation to Distributors and
23 Distributors' sub-agents.
24

25 93. Each of the Trustee Defendants, singly and in concert, engaged in the aforesaid
26 conduct in reckless disregard and/or intentional breach of his or her fiduciary duties to the Trust.
27
28

1 94. Plaintiff, on behalf of the Trust, seeks declaratory and injunctive relief and damages
2 and other relief for the Trust as hereinafter set forth.

3 **FOURTH CAUSE OF ACTION**

4 **Waste of Trust Assets Against The Trustee Defendants**

5 95. Plaintiff incorporates by reference each of the foregoing allegations as if fully stated
6 herein.

7 96. As a result of the unlawful Asset-Based Compensation paid from Trust assets to
8 Distributors and its sub-agents, and by failing to properly consider the interests of the Trust and its
9 shareholders by failing to conduct proper supervision, the Trustee Defendants have caused a *per se*
10 waste of valuable Trust assets through illegal payments from Trust assets.

11 97. As a result of the waste of Trust assets, the Trustee Defendants are liable to the
12 Trust.

13 98. The Trust has no adequate remedy at law.

14 **PRAYER FOR RELIEF**

15 WHEREFORE, plaintiff demands judgment on behalf of the Trust as follows:

16 (1) Determining that this action is a proper derivative action maintainable under
17 law, that the demand requirement was satisfied, and that demand was wrongfully refused;

18 (2) Against each Defendant for restitution and/or damages in favor of the Trust
19 and its shareholders;

20 (3) Declaratory and injunctive relief as permitted by law, including attaching,
21 impounding, imposing a constructive trust on or otherwise restricting the Asset-Based
22 Compensation previously paid to Distributors and enjoining the Trust and Distributors from any
23 further payments of Asset-Based Compensation to broker-dealers in connection with Trust shares
24 held in brokerage accounts in the United States;

25 (4) Awarding pre-judgment interest on all monetary damages;
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(5) Awarding plaintiff the costs and disbursements of this action, including reasonable attorneys', accountants', and experts' fees; and

(6) Granting such other and further relief as this Court may deem just and proper.

JURY TRIAL DEMANDED

Plaintiff hereby demands a trial by jury.

DATED: October 6, 2009

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17 *Attorneys for Plaintiff*
18
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VERIFICATION

I, Bradley C. Smith, under penalties of perjury, state that I have read the foregoing Verified Derivative Complaint and authorize its filing, and that the foregoing is true and correct to the best of my knowledge, information, and belief.

Dated: October 2, 2009

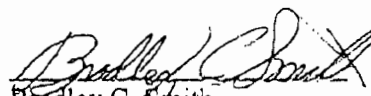

Bradley C. Smith

EXHIBIT 1

MILBERG LLP

NEW YORK
LOS ANGELES
TAMPA

Michael C. Spencer
Direct Dial: 212-946-9450
mspencer@milberg.com

January 8, 2009

Board of Trustees
Franklin Custodian Funds
One Franklin Parkway
San Mateo, CA 94403-1906

Re: Shareholder Demand For Cessation
and Restoration of Certain Payments to Broker-Dealers

Dear Members of the Board of Trustees:

This letter is a shareholder demand that the Board of Trustees of Franklin Custodian Funds ("the Trust") immediately (a) cause the Trust to cease funding and permitting the payment of ongoing non-transactional asset-based compensation ("Asset-Based Compensation") to broker-dealers in connection with Trust shares held in brokerage accounts in the United States, and (b) take all necessary and reasonable steps to restore to the Trust all payments of such Asset-Based Compensation in the past.

This letter is submitted on behalf of Bradley C. Smith, who owns Class C shares of the Franklin Income Fund (FCISX), which is one of five portfolios that comprise the Trust. His shares are held in a brokerage account at Merrill Lynch.

The Trust has elected to act as distributor of shares of which it is the issuer. Pursuant to written distribution plans adopted by the Board, the Trust pays for distribution-related services from the Trust's assets, including payments of Asset-Based Compensation to broker-dealers.

The Trust has appointed Franklin Templeton Distributors, Inc. ("FTD") as the Trust's exclusive agent for performing distribution-related services, either directly or through third parties. Distribution agreements between the Trust and FTD authorize payments of Asset-Based Compensation to broker-dealers. These payments are set at an annual percentage rate of average daily net asset values of shares of the Trust and are disbursed quarterly. For example, in the fiscal year ending September 30, 2008, the Trust funded payment of approximately \$99.2 million in Asset-Based Compensation to broker-dealers pursuant to a distribution plan for Class C

Milberg LLP

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January 8, 2009
Page 2

shares. Additional Asset-Based Compensation payments to broker-dealers are described as "marketing support payments."

Payment of Asset-Based Compensation to broker-dealers in connection with brokerage accounts is unlawful under the Investment Advisers Act of 1940, as confirmed in *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

Smith asserts that present and former Trustees acted with malfeasance and/or failed to properly exercise adequate oversight in approving unlawful Asset-Based Compensation to broker-dealers, which caused waste and injury to the Trust and reduced shareholders' investment returns.

Smith demands that the Board of Trustees:

1. Cause the Trust to cease funding or permitting payments of Asset-Based Compensation to broker-dealers in connection with shares of the Trust held in brokerage accounts in the United States, and terminate or reform all distribution plans and distribution agreements by which the Trust funds or permits such unlawful payments.
2. Take all reasonable and necessary steps, including litigation, to restore to the Trust all payments of Asset-Based Compensation to broker-dealers in connection with shares of the Trust held in brokerage accounts in the United States, including but not limited to obtaining recovery from present and former Trustees of the Trust and/or FTD.

We respectfully request a response to this demand within 60 days. If a satisfactory response is not received, we intend to commence a derivative action on behalf of the Trust.

Sincerely,



Michael C. Spencer

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Milberg LLP

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MCS

Sent To Board of Trustees
Franklin Custodian Funds

Street, Apt. No.,
 or PO Box No. One Franklin Parkway

City, State, ZIP+4 San Mateo, CA 94403-1906

PS Form 3800, June 2002 See Reverse for Instructions

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1. Article Addressed to:

Board of Trustees
 Franklin Custodian Funds
 One Franklin Parkway
 San Mateo, CA 94403-1906

2. Article Number

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- ☐ Agent
☐ Addressee

B. Received by (Printed Name)**C. Date of Delivery**

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☐ Registered ☐ Return Receipt for Merchandise
☐ Insured Mail ☐ C.O.D.

4. Restricted Delivery? (See a Fee)

- ☐ Yes

EXHIBIT 2

BLEAKLEY PLATT

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March 4, 2009

Via: Certified Mail/Return Receipt Requested

Michael C. Spencer, Esq.
Milberg LLP
One Pennsylvania Plaza
New York, NY 10119-0165

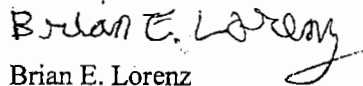
Re: *Smith Demand Letter of January 8, 2009*

Dear Mr. Spencer:

My firm is counsel to the Trustees of the Franklin Custodian Funds who are not "interested persons" of such Fund as defined in the Investment Company Act of 1940 (the "Independent Trustees") and at the request of the Board of Trustees of the Fund am responding on its behalf to the demands of Bradley C. Smith set forth in your January 8, 2009 letter.

The Board of Trustees has carefully considered Mr. Smith's demands on behalf of the Trust, and has sought and considered legal advice on the subject matter of the demands. The Board of Trustees has determined that the demands are not well-founded, as a matter of law, and declines to take the steps, including litigation, that you propose.

Sincerely yours,


Brian E. Lorenz

BEL/m